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3 good reasons to bring back the bond ladder

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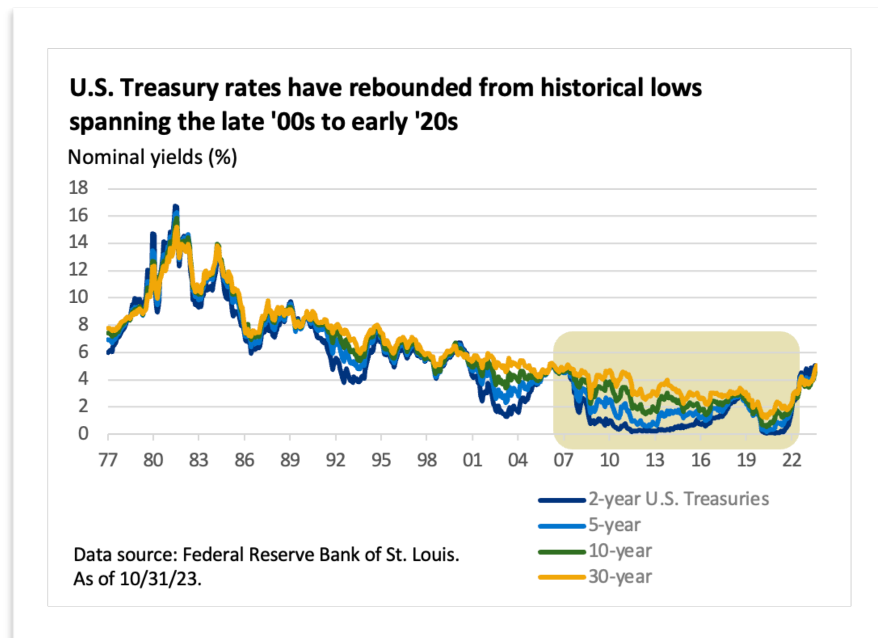
When interest rates were at their lowest, a period that stretched from the Great Financial Crisis of 08-09 up until the pandemic, there wasn't much benefit to assembling a classic bond ladder in portfolios. What's the difference between a low-yield 2-year bond and a low-yield 5-year bond? Well, not much. But the return of yield could also bring back the benefits of this traditional investment strategy. Here's a quick recap of what bond ladders are and a few of the good reasons investors use them.

U.S Treasury rates have rebounded from historical lows spanning the late '00s to early '20's



A line chart showing nominal yields on U.S. Treasuries from 1977 to October 2023. The chart shows the paths of yields for four different maturities of Treasuries: 2-year, 5-year, 10-year and 30-year bonds. The chart demonstrates that yields were generally higher in the 70s, 80s and 90s, falling to record lows in the 00s, 10s and early 20s. Recently, yields have started to climb from lows.

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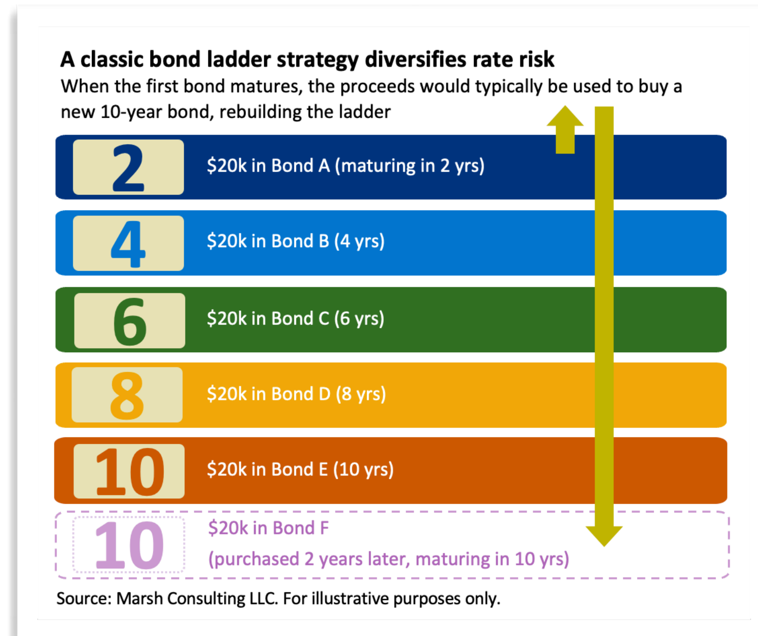
Understanding the bond ladder

Bond ladders are simply a way of staggering your bond holdings so that their maturity dates span time intervals like the rungs on a ladder. For example, you might divide your bond allocation evenly across a mix of five bonds, where the first matures in two years, the second matures in four years, the third matures in six years, the fourth matures in eight years and the fifth matures in 10 years.



A visual shows an imagined bond ladder, which is a concept of buying a mix of bonds that mature across a span of maturities like the rungs of a ladder. The graphic shows imagined bonds maturing in 2 years, 4 years, 6 years, 8 years and 10 years. When 2 years have passed and the first 2-year bond matures, the proceeds are used to purchase a new 10-year bond, rebuilding the ladder.

Since time is always rolling forward, every day brings you closer to the maturity of your bonds. When the shortest one matures and the principal is repaid to you in cash – two years from the day you first bought all those bonds – the bond-ladder strategy generally holds that you'll take that cash and use it to buy a new 10-year bond. Now you've started the ladder all over again. In two more years, the shortest bond will mature, and you'll take the cash and buy a new 10-year bond, and so on.

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The bond ladder strategy, simple as it is, offers a few appealing benefits:

• 1 You get exposure to a mix of different durations.

Scroll back up to that earlier chart of U.S. Treasury yields for different maturities – sometimes they're all clumped together, and sometimes they fan out. In other words, sometimes there is a big difference between short-term yields and long-term yields, suggesting a large benefit to those who capture the difference – but sometimes long- and short-term rates are nearly the same.

Bond ladders are a way of intentionally diversifying across maturities. Interest rates might seem like a sleepy corner of the investment world, but there is actually a lot of variation in the yield curve. Long-term rates are most often higher, but there are also periods where short-term rates are higher and periods where rates are nearly equal no matter what the maturity. A ladder strategy ensures that you have exposure to the "best" end of the yield curve in every environment.

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• 2 Rate risk: There's always a refresh around the corner.

Another look at that U.S. Treasury yield chart will highlight another feature of interest rates – they are always moving. When market rates are moving up, hold-to-maturity bondholders may feel the sting of missing out on rising yields. When market rates are falling, hold-to-maturity bondholders are probably wishing they had locked in even more of their current bonds, whose cushy yields are looking ever more appealing by the day.

Bond ladders offer a nice balance across these dynamics. They lock in current yields across as much duration as investors want, but there is always a liquidity event – an upcoming bond maturity – on the horizon. When the shortest bond matures, the usual strategy is to reinvest it in the longest ladder duration, as in the 10-year example discussed above. But investors could hold off if the environment is too extreme. There is some flexibility around the liquidity event.

• 3 Cash flow is part of the design.

Classic bond ladders generate cash flow by design. Typically assembled with coupon-paying bonds, they'll kick off interest payments during the holding period and larger principal-repayment cash flows at maturity. This is often a plus for retirees and other investors looking to create regular cash flow from investments.

For some investors, it can drive a surplus of liquidity over time, so that is an important consideration in the context of an overall portfolio strategy. However, for those who like the cash flow aspect, it can be a nice structure to plan spending and reinvestment decisions.

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• 4 Bond ladders offer the opportunity to manage the yield curve.

There are instances when you may not want to invest in longer term securities, depending on your interest rate outlook. Rather than roll maturing bonds at the end of our ladder (ten years, in this example), current clients saw us dramatically shorten our maturities in 2020 in anticipation of higher rates once the fed started tightening.

Conversely, we have taken advantage of the recent runup in rates by locking in longer term maturities, thus ensuring a steady stream of income over the next decade.

Could a traditional bond ladder suit your needs? Reach out to discuss.

There's a lot to like about this approach to incorporating fixed income into your portfolio, particularly in an environment where yields are at appealing levels.

We're happy to talk about your situation anytime. Let's connect.

Important disclosures Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can cause a bond's price to fall. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity. Bond laddering does not assure a profit or protect against loss in a declining market.

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